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**HANDLING**

**~~NET MARGINS~~**

**~~UNDER THE~~**

**~~NEW TAX LAW~~**

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The Service publishes the results of such studies; confers and advises with officials of farmer cooperatives; and works with educational agencies, cooperatives, and others in the dissemination of information relating to cooperative principles and practices.

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# Handling Net Margins Under the New Tax Law

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The "new tax law" farmer cooperatives talk about is Section 17 of the Revenue Act of 1962, approved October 16, 1962.

This section adds a new Subchapter T to the Internal Revenue Code of 1954. It applies to all farmer cooperatives and certain other corporations operating on a cooperative basis. It is effective in taxable years that begin after December 31, 1962.

The new law preserves the principle of a single, current tax on income produced through farmer cooperatives, provided they meet these conditions:

1. Adhere to certain requirements as to the form in which they distribute patronage refunds.

2. Make the distributions within the prescribed time.

In the process of conforming with the new law, however, a number of

alternatives are available which must be evaluated and on which decisions must be made. Let us now throw the spotlight on these crossroads where choices are available.

## Choice 1

The changes made by Section 17 do not repeal or modify in any way the requirements of Section 521 of the Internal Revenue Code of 1954 relating to qualification for a letter of exemption. Such a letter entitles an eligible farmer cooperative to two special deductions:

1. Amounts paid as dividends during the taxable year on capital stock (which has been construed to include any form of return on all genuine capital interests); and

2. Amounts of nonpatronage income (such as income on business with the United States, rents, and interest) paid out on a patronage basis, if distributed within 8 1/2 months after the year in which they were derived.

Thus the first alternative a farmer cooperative faces is whether to operate in compliance with the requirements of Section 521. Obviously, if the cooperative does operate under these requirements, it does not pay taxes on: (1) The part of its margins devoted to a return on capital interests

and (2) the part arising from non-patronage activities, including business done for or with the United States.

If the cooperative decides not to qualify under the requirements of Section 521, the cooperative will always pay taxes at regular corporate rates on a portion of its net margins.

## Choice 2

The next choice the cooperative faces relates to the form and time in which it pays its patronage refunds. For, to emphasize, it is the form and timing of the refunds which determine their tax treatment under the new law, at both the cooperative level and, in the main, at the patron level.

The new law lays down precise rules on the circumstances under which farmer cooperatives (both "exempt" and nonexempt) may use patronage refunds to reduce their gross income for tax purposes.

First -- The refund must meet the definition of a "patronage dividend" set forth in the statute. This means that the refund must be --

1. Computed on the basis of quantity or value of business done with or for the patron;

2. Made pursuant to a pre-existing written obligation of the cooperative; and

3. Determined by reference to the net earnings of the organization from business done with or for patrons. (This excludes true "capital retains" from sales proceeds.)

Second -- The refund must be paid in cash, property of a kind on which a current value can be placed, or in what the statute calls "qualified written notices of allocation."

Third -- The refund must be "paid" within 8-1/2 months following the close of the cooperative's fiscal year. (The statute calls the 12-month fiscal year plus this 8-1/2 months period the cooperative's "payment period.")

### Choice 3

A third area of choice is in qualifying the "written notices of allocation." In all cases, these allocations to be "qualified" must meet the following requirements:

1. They must be in the form of a document that discloses the amount of the allocation and the portion thereof which is a patronage dividend (as compared to distributions of non-patronage income);

2. At least 20 percent of this patron-



age dividend must be paid in cash.

At this juncture, however, the cooperative can choose between issuing the paper (1) under circumstances in which it has a form of patron's consent, or (2) in a form redeemable in cash by the patron within a period of 90 days following the date of issuance.

## Choice 4

If the cooperative elects to get a form of patron's consent, it again faces choices -- three to be exact:

### 1. Individual patron's written consent

This form of consent must be given to the cooperative before the end of the year in which the patronage occurs. It applies to all patronage in that year. It also covers patronage in subsequent taxable years until a written revocation becomes effective.

A revocation is effective only on patronage occurring after the close of the cooperative's taxable year in which it is given.

### 2. Consent by membership

The patron may consent by obtaining or retaining membership in a cooperative having bylaws that require members, as a condition of membership, to take qualified written notices of

allocation into account currently in computing their Federal income tax liability.

The bylaw must have been adopted after October 16, 1962, and it must clearly set forth this obligation. The consent under this method becomes effective only on patronage occurring after each patron receives a written notification of the adoption of the bylaw that explains its significance. A copy of the bylaw must accompany the notification.

Mailing this material by ordinary mail to the patron's last-known address is permitted. New members must have this material before becoming members. Termination of membership terminates this form of consent.

### 3. Consent by qualified check

If neither of the first two methods is applicable, a patron may consent by endorsing and cashing a check or other instrument redeemable in money that represents at least 20 percent of the total patronage refund, and has clearly imprinted on it that endorsing and cashing it will constitute such consent.

This endorsement and cashing must take place within 90 days following the end of the cooperative's payment period (see definition previously given to constitute a valid consent).

This latter method is a "oneshot" deal, applying only to the patron-

age refund of which the check is a part.

## Choice 5

Implicit in choice three, discussed above, is the alternative to pay some or all patronage refunds in the form of nonqualified written notices of allocation. A cooperative may deliberately elect to do this simply by failing to comply with one or all of the requirements as to form of the allocation discussed above. In this event, it incurs a current tax liability. A deduction is available, however, when the nonqualified allocation is redeemed in cash. If a deduction cannot be utilized, a refund of tax paid is available.

Under the final regulations (28 Fed. Reg. 3152), an exempt cooperative, without losing its exemption, has two further choices:

1. It may pay patronage refunds of less than \$5 in nonqualified allocations even to consenting members; or

2. If it issues, to nonconsenting patrons, nonqualified patronage allocations which are interest bearing or in the form of dividend-paying stock, it may make deductions (reasonable in relation to the fact that it receives no tax benefit on such allocations until redemption) in the interest or dividends paid.

The foregoing analysis suggests that there is a substantial amount of flexibility in the Code provisions. Farmer cooperatives do, in fact, have alternative methods of handling net margins under the new tax law. Each cooperative must determine the courses that will best fit its particular operations.



## Other Publications Available

How the Revenue Act of 1962 Affects Farmer Cooperatives, FCS General Report 105. Raymond J. Mischler and David Volkin.

Methods of Financing Farmer Cooperatives, FCS General Report 32. Helim H. Hulbert, Nelda Griffin, and Kelsey B. Gardner.

What Are Patronage Refunds? FCS Information 34. Kelsey B. Gardner.

Trends in Growth of Farmer Cooperatives, FCS General Report 110. Kelsey B. Gardner and Anne L. Gessner.

How Farmer Cooperatives Contribute to Agricultural Well-Being, FCS Information 37. Joseph G. Knapp.

Statistics of Farmer Cooperatives, 1960-61, FCS General Report 112. Anne L. Gessner.

A copy of each of these publications may be obtained upon request while a supply is available from --

Farmer Cooperative Service  
U. S. Department of Agriculture  
5a Washington, 25, D. C.